FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429

Division of Insurance

October 19, 2001

MEMORANDUM TO: Board of Directors

FROM: Arthur J. Murton, Director
Division of Insurance

SUBJECT: BIF Assessment Rates for the First
Semiannual Assessment Period of 2002

Recommendation

The staff recommends that the Board maintain the existing Bank Insurance Fund (BIF) assessment rate schedule of 0 to 27 basis points (bp) per year. This rate schedule complies with the statutory requirements for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the target Designated Reserve Ratio (DRR), currently 1.25 percent.

Summary

The Federal Deposit Insurance Act (FDI Act) governs the authority of the Board to set BIF assessment rates and directs the Board to establish a risk-based assessment system for insured depository institutions and set assessments to the extent necessary to maintain the reserve ratio at 1.25 percent. The reserve ratio for the BIF stood at 1.33 percent (unaudited) as of June 30, 2001, and it is most likely that the reserve ratio will remain above 1.25 percent through June 30, 2002 unless realized insurance losses and deposit growth are both at the high end of their projected ranges. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the first semiannual period of 2002, and the staff consequently recommends no changes to the rate schedule.

Some institutions will pay premiums under this schedule even though the reserve ratio exceeds the target DRR; however, the view of the staff is that the current schedule is consistent with the statutory requirement to establish a risk-based assessment system. Based on June 30, 2001 data and projected ranges for the relevant variables at June 30, 2002, this rate schedule would result in an average annual assessment rate of approximately 0.15 bp.

ANALYSIS

In setting assessment rates since recapitalization of the BIF, the Board has considered: (1) the balance between revenues and expenditures over time, (2) the statutory requirement to maintain the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.[1]

Long-Run Considerations

Based on a thorough review of FDIC experience and consideration of statutory changes designed to moderate future deposit insurance losses (e.g., prompt corrective action authority, national depositor preference and the least-cost resolution requirement), analysis conducted by FDIC staff at the time of the BIF recapitalization concluded that an effective average assessment rate of 4 to 5 bp annually would be appropriate to achieve long-run balance between BIF revenues and expenses (where expenses include funds needed to prevent dilution due to deposit growth). Thus, in 1995, the "base" rate schedule for the BIF was established at 4 to 31 bp annually. Given conditions of slow to moderate deposit growth and minimal insurance losses, which reduced the need for assessment revenue, the Board shifted the effective annual

[1] The Board is required to review and weigh the following factors when establishing an assessment schedule: a) the probability and likely amount of loss to the fund posed by individual institutions; b) case resolution expenditures and income; c) expected operating expenses; d) the revenue needs of the fund; e) the effect of assessments on the earnings and capital of fund members; and f) any other factors that the Board may deem appropriate. These factors directly affect the reserve ratio prospectively and thus are considered as elements of the requirement to set rates to maintain the reserve ratio at the target DRR.

rate schedule downward to 0 to 27 bp as of 1996.[2] The Board did not alter the base rate schedule, which remains today at 4 to 31 bp. In recommending that the Board maintain the base schedule at 4 to 31 bp, the staff previously expressed the view that a rising BIF reserve ratio was not necessarily indicative of a long-run trend, given the historical volatility of deposit growth and insurance losses. The recent decline in the reserve ratio supports this view and demonstrates the volatility of the reserve ratio.

Maintaining the Target DRR Over the Next Assessment Period

The BIF reserve ratio stood at 1.33 percent as of June 30, 2001 (unaudited), the latest date for which complete data are available. In view of the current and projected levels of the BIF reserve ratio, the current rate schedule will likely be adequate to maintain the statutory target DRR of 1.25 percent.

Many backward looking measures of bank and thrift financial condition indicate that the industry has continued its strong performance. However, there were indications prior to the events of September 11, 2001 that the economy was slowing, and many theorize that the economic fallout from the attacks will intensify this trend. This would likely cause measures of bank and thrift health to weaken during the upcoming assessment period and would likely increase losses to the BIF. The magnitude of the increase is difficult to quantify without knowing the depth or duration of economic weakness. Another uncertainty is the growth rate of insured deposits. Strong deposit growth coupled with a substantial increase in losses could drop the BIF reserve ratio to 1.25 percent or below during the upcoming assessment period.

[2] The FDIC may alter the existing rate structure and may change the base BIF rates (currently 4 to 31 bp) by rulemaking with notice and comment. Without a notice-and-comment rulemaking, the Board has authority to increase or decrease the effective rate schedule uniformly up to a maximum of 5 bp, as deemed necessary to maintain the target DRR.

Industry asset quality continues to weaken as banks charged off $7.9 billion in loans during the second quarter, a 50 percent increase from one year ago. Despite increased chargeoffs, the volume of noncurrent loans increased 33 percent during the same period. Loan loss reserves continue to grow, but more slowly than the volume of noncurrent loans. The coverage ratio fell for six consecutive quarters to stand at 1.35x in the second quarter.

Despite the concerns noted above, there are reasons to believe that the industry is capable of withstanding significant stress. Commercial banks' ROAs were 1.21 percent during the second quarter, down from 1.27 percent during the first quarter, but up from 0.99 percent a year ago. A six-quarter trend of declining net interest margins (NIMs) ended during the second quarter when NIMs rose to 3.86 percent. The industry's leverage capital ratio increased from 7.68 percent to 7.73 percent during the second quarter. If the economy is heading into a recession, the banking industry is better capitalized and appears better able to weather bad economic times than in prior recessions.

Estimated BIF-insured deposits grew 6.4 percent during the year ending June 30, 2001, while the BIF grew by 6.38 percent. The reserve ratio remained steady at 1.33 percent. Staff believes that rapid deposit growth may continue through the end of 2001 and into 2002. The potential drivers of this growth include stock market volatility, accommodative monetary policy and investor flight to safety.

Despite concerns regarding the potential for higher BIF losses and accelerating deposit growth, the staff believes it is unlikely that the reserve ratio will fall below 1.25 percent during the upcoming assessment period. Following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the reserve ratio through June 30, 2002.

1. Fund Balance

The BIF unaudited balance was $31.681 billion on June 30, 2001. Changes in the balance over the short run are determined largely by insurance losses, interest income, and unrealized gains and losses on available-for-sale (AFS) securities.

Insurance Losses. Insurance losses consist of two components: a contingent liability for future failures and an allowance for losses on institutions that have already failed. Potential changes in contingent liabilities for the twelve months ending June 30, 2002 reflect the range of June 30, 2001 estimates from the Financial Risk Committee (FRC) plus any adjustments for: (1) potential losses on failures that have occurred since June 30, 2001; and (2) potential failures identified subsequent to the FRC's estimates. The resulting range for changes in contingent liabilities is $200 million to $750 million.

Table 1 projects low and high estimates for the provision for losses based on the changes in contingent liabilities and an adjustment for the net recovery value of closed banks in receivership as of June 30, 2001.

Table 1
Potential Changes in Contingent Liabilities and Allowance for Losses (1)
June 30, 2001 to June 30, 2002

	Low Loss Estimate	**High Loss Estimate**
Contingent Liability for Future Losses	$200 million	$750 million
Allowance for Losses: Closed Banks (2)	($5 million)	$5 million
Total Provision for Losses	$195 million	$755 million

Notes:

(1) Both projections reflect the information available as of September 30, 2001, regarding future economic conditions.

(2) Where point estimates for net recovery value are available, this reflects an allowance for variation of +/- 5% around the point estimate. Where point estimates are not available, this reflects the estimated range of net recovery values for the resolution.

Interest Income and Unrealized Gains and Losses on AFS Securities. The average BIF investment portfolio for the twelve months ending June 30, 2002 is estimated to be approximately $31.4 billion. Based on the possibility of a shift in the level of interest rates of plus or minus 100 bp for new investments, interest income is projected to be between $1.848 billion and $1.892 billion for the twelve months ending June 30, 2002. Because of the significant percentage of AFS securities held in the insurance fund portfolio at this time, when interest rates change, the magnitude of the change in market value of the securities dominates the effect of changes in interest income. Therefore, in Table 2 the higher interest rate scenario drives the low projected fund balance.

Table 2 summarizes the effects on the fund balance of the low and high estimates that define the ranges assumed for interest income, unrealized gains and losses on AFS securities, and insurance losses.

Table 2
Projected Fund Balance (1)
($ in millions)

	Low Projected Balance	**High Projected Balance**
Assessments (2)	52	52
Interest Income (3)	1,892	1,848
Total Revenue	1,944	1,900
Operating Expenses	800	800
Provision for Losses	755	195
Total Expenses & Losses	1,555	995
Net Income	389	905
Unrealized Gain (Loss) on AFS Securities (3)	(121)	305
Comprehensive Income (Loss) (4)	268	1,210
Fund Balance (Unaudited) – 6/30/01	31,681	31,681
Projected Fund Balance – 6/30/02	31,949	32,891

Notes:

(1) Projected income and expense figures are for the twelve months from June 30, 2001, through June 30, 2002.

(2) Assumes that the current assessment rate schedule remains in effect through June 30, 2002.

(3) Portfolio yield is estimated to be between 5.89 percent (high projected balance) and 6.02 percent (low projected balance), reflecting a shift in the level of interest rates of + or – 100 bp from the level of interest rates as of the beginning of September 2001. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities more than offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. The average invested fund balance is estimated to be approximately $31.4 billion. Unrealized Gain (Loss) on AFS securities includes $89 million in gains for July and August 2001.

(4) Comprehensive Income is used instead of Net Income due to the magnitude of the change in market value of AFS securities that occurs with fluctuations in interest rates. See note (3).

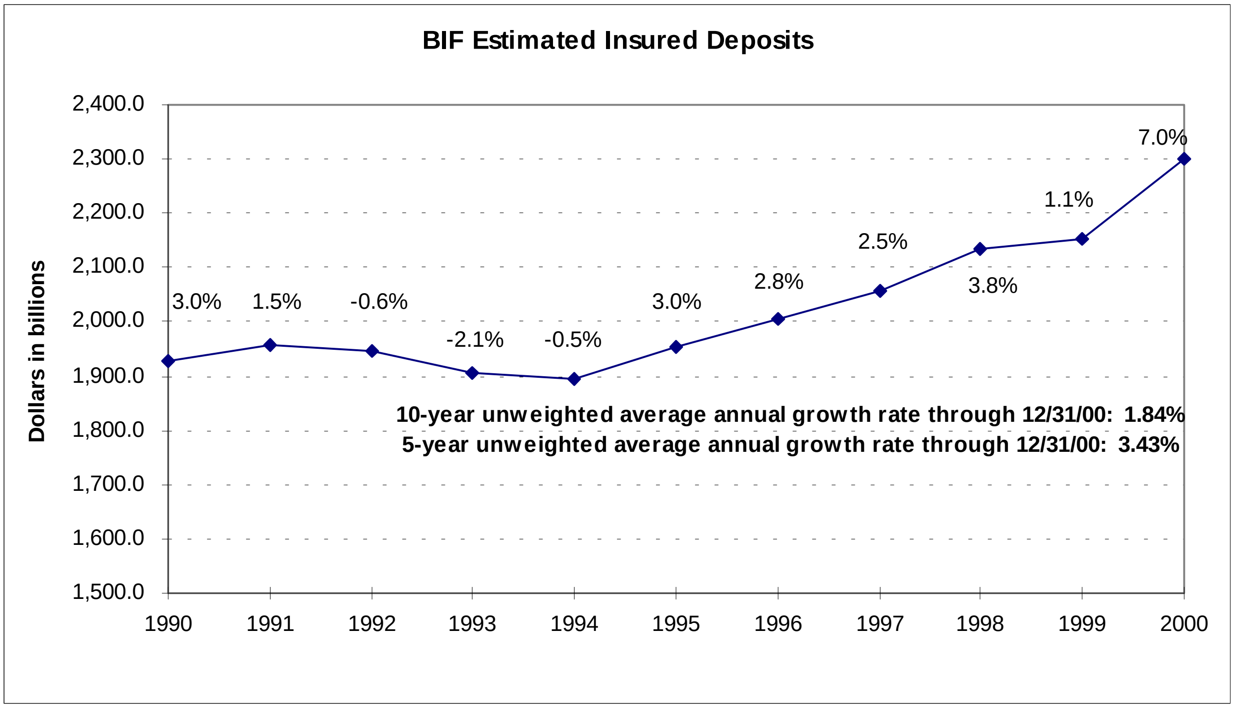
2. Insured Deposits

Since 1990, annual growth of BIF-insured deposits has been as high as 7.0 percent and as low as an annual shrinkage of 2.1 percent (see Figure 1, next page). After shrinking annually from 1991 through 1994, insured deposits grew between 2.5 percent and 4.0 percent from 1995 to 1998. After minimal growth in 1999 (1.1 percent), insured deposits grew by 7 percent in 2000, which was the highest annual growth rate since 1990. During the twelve months ending June 30, 2001, BIF-insured deposits grew 6.4 percent. Sweep activity, equity market declines and an increase in the money supply resulting from Federal Reserve Bank actions have factored into the recent increase in insured deposits.

The Federal Reserve has continued to lower short-term interest rates through 2001, which could make bank deposits less attractive due to lower rates; however, continued stock market volatility and investors' concerns for safety suggest that deposits may remain an attractive investment as we approach the upcoming assessment period.

It takes approximately $18 billion in estimated insured deposit growth to create a 1 basis point change in the BIF reserve ratio, all other things held constant. With the reserve ratio currently at 1.33 percent, it would therefore take about $144 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else being equal. As of June 30, 2001, $144 billion is about 6 percent of estimated insured deposits. Using the low estimate for the fund balance at June 30, 2002 insured deposits would have to grow 7.68 percent during the year ending on June 30, 2002 to cause the reserve ratio to fall below 1.25 percent. Thus, only if insurance losses rise significantly in combination with rapid deposit growth would the reserve ratio fall below its target during the upcoming assessment period.

Figure 1



Considering the experience of the last five years and current market conditions, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of +3 percent to +9 percent between June 2001 and June 2002. The high end of this range reflects the potential for continued rapid deposit growth caused by stock market volatility, investor concern for safety and accommodative monetary policy.

3. BIF Reserve Ratio

Based on the projected BIF balance and the growth of the insured-deposit base, the staff projects the BIF reserve ratio to be within the range of 1.23 percent to 1.34 percent at June 30, 2002 (Table 3, next page). The low estimate, which produces a 10 bp decrease from the June 30, 2001 ratio, reflects an assumed stronger increase in the insured deposit base (+9 percent) and a downward adjustment to the fund balance for an assumed reduction in the aggregate amount of unrealized gains on AFS securities (see Table 2). The low estimate also reflects the highest losses from possible near-term failures as projected by staff; the estimate is not intended to represent a "worst-case" scenario. The high estimate produces an increase of 1 bp above the June 30, 2001 level, and reflects +3 percent growth in the BIF-insured deposit base and a stronger increase in the BIF balance due to lower insurance losses and an upward adjustment for an assumed increase in the aggregate amount of unrealized gains on AFS securities.

Table 3
Projected BIF Reserve Ratios
($ in millions)

	June 30, 2001	
Fund Balance (Unaudited)	$31,681	
Estimated Insured Deposits	$2,383,235	
BIF Ratio	1.33%	
	Low Estimate (1) **June 30, 2002**	**High Estimate** (2) **June 30, 2002**
Projected Fund Balance	$31,949	$32,891
Estimated Insured Deposits	$2,597,726	$2,454,732
Estimated BIF Ratio	1.23%	1.34%

Notes:

(1) The low estimate refers to the scenario of higher interest rates (portfolio yield: 6.02 percent, because of unrealized losses on AFS securities-see note 3 in Table 2), a higher provision for losses ($755 million) and a higher insured deposit growth rate (+9 percent).

(2) The high estimate refers to the scenario of lower interest rates (portfolio yield: 5.89 percent, because of unrealized gains on AFS securities-see note 3, Table 2), a lower provision for losses ($195 million) and a lower insured deposit growth rate (+3 percent).

As indicated in Table 3, if the low estimate were to be realized, the current rate schedule would not be sufficient to maintain the DRR through June 30, 2002. Staff believes that such a scenario is possible, but not likely because the low estimate requires sustained rapid deposit growth, high losses and a substantial increase in interest rates to occur during the assessment period.

Risk-based assessment system. The staff recommends retaining the current spread of 27 bp between the highest- and lowest-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. The proposed assessment rate schedule, ranging from 0 to 27 bp per year, appears in Table 4. The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments. The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

In setting assessment rates to achieve and maintain the reserve ratio at the target DRR, the Board is required to consider the effects of assessments on members' earnings and capital. The estimated annual revenue from the existing rate schedule is $52 million, $9 million more than the previous period. In recommending that the Board maintain this schedule, the staff has considered the impact on earnings and capital and found no unwarranted adverse effects.

Table 4
Proposed Assessment Rate Schedule
First Semiannual Assessment Period of 2002
BIF-Insured Institutions

Capital Group	A	B	C
1. Well	**0 bp**	**3 bp**	**17 bp**
2. Adequate	**3 bp**	**10 bp**	**24 bp**
3. Under	**10 bp**	**24 bp**	**27 bp**

The Assessment Base Distribution and Matrix Migration

Table 5 summarizes the distribution of institutions across the assessment matrix.

Table 5
BIF Assessment Base Distribution (1)
Deposits as of June 30, 2001
Supervisory Subgroup and Capital Groups in Effect July 1, 2001

Capital Group		A		B		C	
1. Well	Number	7,828	92.7%	394	4.7%	52	0.6%
	Base ($billion)	3,292.4	96.3%	84.4	2.5%	5.5	0.2%
2. Adequate	Number	140	1.7%	21	0.2%	7	0.1%
	Base ($billion)	31.5	0.9%	2.1	0.1%	1.9	0.1%
3. Under	Number	1	0.0%	0	0.0%	5	0.1%
	Base ($billion)	0.2	0.0%	0	0.0%	0.5	0.0%

Estimated annual assessment revenue	$ 52 million
Assessment Base	$3,418.4 billion
Average annual assessment rate (bp)	0.15 basis points

Notes:

(1) "Number" reflects the number of BIF members, including BIF-Oakar institutions; "Base" reflects all BIF-assessable deposits.

With 99.1 percent of the number of institutions and 99.7 percent of the assessment base in the three lowest assessment risk classifications of “1A,” “1B,” and “2A,” as of July 1, 2001, the current distribution in the rate matrix reflects little fundamental difference from the previous semiannual assessment period. The current distribution reflects slight deterioration in the best-rated premium category. Since the previous assessment period, 171 institutions migrated into the "1A" risk classification (see Table 6), and 190 institutions migrated out of the "1A" risk classification. Only 620 institutions are classified outside of the lowest assessment risk classification.

Overall, the supervisory subgroup assignment was upgraded since the previous period for 108 institutions with an assessment base of $10.6 billion and was downgraded for 136 institutions with an assessment base of $19.7 billion.

Table 6

BIF Migration To and From Assessment Risk Classification "1A" (1)

Institutions entering "1A"	Number	Base ($billion)
Due to capital group reclassification only	81	15.8
Due to supervisory subgroup reclassification only	89	8.9
Due to both	1	0.2
Total	171	24.9
Institutions leaving "1A"	**Number**	**Base ($billion)**
Due to capital group reclassification only	76	20.9
Due to supervisory subgroup reclassification only	109	15.5
Due to both	5	0.3
Total	190	36.7

Notes:

(1) Reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the first semiannual assessment period of 2001 to the second semiannual assessment period of 2001. The numbers only include institutions that were rated in both periods.

Other Issues

Refunds for second semiannual period of 2001. According to the Deposit Insurance Funds Act of 1996 (Funds Act), if the reserve ratio at the end of an assessment period exceeds the DRR, the Board is required to refund such excess amount, to certain insured depository institutions. However, this refund may not exceed the amount paid in that assessment period, and refunds may not be made to institutions that exhibit certain weaknesses (financial, operational, or compliance) or are not well-capitalized. The FDIC interprets the Funds Act as requiring refunds only to those institutions classified as "1A" for purposes of the FDIC's risk-related premium system. Since BIF-insured institutions classified as "1A" currently pay no assessments to the BIF under the proposed rate schedule they are ineligible to receive any refund for the first semiannual period of 2002.

FICO Assessment. The Funds Act separates the Financing Corporation (FICO) assessment from the FDIC assessment, so that the amount assessed on individual institutions by the FICO is in addition to the amount paid according to the BIF rate schedule. All institutions are assessed the same rate by FICO, as provided for in the Funds Act. The FICO rate for the first annual assessment period of 2002 (subject to quarterly adjustment) will be determined using September 30, 2001, Call Report and Thrift Financial Report data in December 2001.

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